

Review of the EU Emissions Trading Directive: Ofgem's response

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Overview:

We strongly support the EU emissions trading scheme (EU ETS). We think a cap and trade scheme is the best way to reduce carbon emissions to help tackle the challenge of global warming. We think a trading scheme will help to reduce carbon emissions from the energy sector at the lowest possible cost to energy customers. Although establishing the EU ETS was a significant and important achievement, we think that early experience of operating the EU ETS has highlighted a number of problems. The review provides a good opportunity to fix these problems. This should help build confidence in cap and trade schemes as the best way to tackle climate change and could ease the transition to the development of an international carbon emissions reduction market.

We think that the EU ETS should be improved to: provide clear long-term carbon reduction targets, allocate allowances through auctions and be broadened in scope to cover other sectors that are major carbon emitters. We think these adjustments would improve the long-term incentives for companies, including gas and electricity companies to invest in low carbon technologies. It should also encourage the creation of a liquid, global carbon market that will help to reduce the costs of tackling climate change.

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Context

The Commission is required under Article 30 of the EU emissions trading directive to conduct a review of the EU emissions trading scheme (EU ETS). Any changes to the Directive from the review should take effect at the start of the third trading period in 2013.

The Commission published a report in November 2006 analysing the performance of the scheme and setting out the terms of reference for the review. The Commission has invited all interested parties to submit their views on the review of the EU ETS and how it should be designed.

This document is Ofgem's response to the review. It sets out our view on the main issues the review will address and the adjustments which should ensure the scheme delivers to its maximum potential.

Associated Documents

- Building a global carbon market – Report pursuant to Article 30 of Directive 2003/87/EC
http://ec.europa.eu/environment/climat/emission/pdf/com2006_676final_en.pdf
- The EU Emissions Trading Directive 2003/87/EC
http://europa.eu.int/eur-lex/pri/en/oj/dat/2003/l_275/l_27520031025en00320046.pdf

Table of Contents

Summary	1
Current framework	1
Main Issues	2
1. Introduction	3
Introduction	3
Context	3
2. Main issues in the review	7
(1) Scope of the Directive	7
Combustion and small installations.....	7
Other sectors and gases	8
Unilateral inclusion of additional activities and gases.....	8
Carbon capture and geological storage	8
(2) Further harmonisation and increased predictability	8
Setting of the cap.....	9
Predictability.....	9
Allocation of allowances to sectors and installations.....	10
Auctioning	10
Free allocation.....	10
New Entrants	11
Installations that close	11
Monitoring and reports	12
(3) Robust compliance and enforcement	12
Monitoring and reporting	12
Verification and compliance.....	13
(4) Linking with emissions trading schemes in third countries, and appropriate means to involve developing countries and countries in economic transition	13
Possibility of linking the EU ETS to schemes in third countries	13
Developing countries and countries in economic transition.....	13
Appendices	14
Appendix 1– The Authority’s Powers and Duties	15
Appendix 2 - Glossary	17

Summary

Ofgem strongly supports the use of broad-based economic instruments as the most cost effective way to encourage the reduction in greenhouse gas emissions (GHG). In order to provide transparent price signals to the market, we support a single price instrument. This enables businesses to assess the relative costs of energy efficiency measures against alternative means of reducing their carbon emissions and, in so doing, make efficient investment decisions.

The Commission published a report in November 2006 setting out the terms of reference for the review. A European Climate Change Programme (ECCP) Working Group on the Review of the EU ETS will be addressing how to improve the functioning, as well as the environmental and cost effectiveness of the scheme, in light of the experience gained from the scheme's operation in the first phase. Central themes that will be addressed in the review are expanding the scope of the scheme, increasing harmonisation and predictability, ensuring robust compliance and enforcement, and the involvement of third countries. The review will have important implications for gas and electricity markets and consumers in Great Britain and across the European Union.

Current framework

The EU ETS is still evolving and the review is an opportunity for the EU to ensure the scheme will deliver carbon savings at the lowest possible cost. The results from 2005 provided a valuable learning phase, however the volatility in the market suggests that some adjustment in the design of the scheme could improve the scheme's effectiveness.

We have been concerned that aspects of the present design undermine the incentives to trade and reduce the efficiency of the scheme. The issues we identify as key are:

- The five year phases and caps are not being set far enough in advance to provide long-term certainty and predictability - this is especially important in the energy sector which is likely to have a significant role to play in reducing emissions across the EU ;
- The restricted coverage of the scheme may be preventing abatement from occurring at the lowest possible cost in industries that are currently excluded from the scheme;
- Greater harmonisation across Member States on key rules covering the setting of national allocation plans and rules governing closure and new entrants would likely result in a more robust and efficient scheme; and
- Allowances should be auctioned - particularly for electricity generators. The free allocation of allowances distorts incentives and has significant distributional impacts. In the electricity sector gives rise to large transfers of money - running to billions of Euros each year from electricity customers to electricity generators.

Ensuring the scheme functions efficiently from 2013 is even more essential given the target to reduce greenhouse gas (GHG) emissions by 20 per cent by 2020 compared

to 1990, which was agreed by the Heads of Government at the 2007 Spring European Council. The IPCC's updated projections of climate change and the conclusions of the Stern Review have highlighted the need to reduce emissions and placed greater emphasis on the role of trading schemes. The review is a chance to improve the structure of the scheme and set a global standard on the design of trading schemes, which achieve carbon savings as well as help in meeting security of supply goals, and influence the development of an international carbon market.

Main Issues

The review addresses the main issues with the current design, which could be affecting the long-term incentives and progress towards a liquid, global carbon market. In general we would support proposals which improve the simplicity, predictability, transparency and harmonisation of the scheme.

The EU ETS should be expanded to cover all sectors that are major GHG emitters. The scheme having the broadest possible coverage should result in abatement occurring at the lowest possible cost. A single EU wide cap would provide greater credibility, and future phases should be longer than five years to be more consistent with timescales for investment particularly in the energy sector which is a major source of carbon emissions.

We have concerns that the existence of new entry reserves and the current closure rules may further distort the incentives of the scheme. New entrant reserves are unnecessary - particularly if allowances are auctioned - and provide an incentive to overstate entry requirements. Closure rules that require installations permanently closing to forfeit their rights to future allocation could also lead to perverse incentives on parties to keep plant open, operating at a minimum efficient level, in order to retain their allocation rights. As plant closure can be considered a legitimate emission abatement option, we would favour an approach that when a plant closes it retains emissions allowances (including to future allocation).

Overall, we would support full auctioning in third phase as the most efficient method for allocation, ensuring that allowances are allocated to those who value them the most. Auctioning would also resolve the issues related to new entry reserves and closure rules, making the scheme less complicated and reducing the administrative burden. If full auctioning of allowances cannot be achieved for this phase, risks will remain that rules relating to closure or new entrant reserve could lead to market distortions. We also recognise that it may make sense to treat some sectors differently to others up front. Therefore, to the extent that full auctioning of allowances is not achievable for this phase, in our view it would be best to allocate allowances in those sectors that face international competition (e.g. heavy manufacturing) and to auction allowances in those sectors that do not (e.g. energy).

We would welcome links to emission trading schemes in third countries and developing countries; this should increase flexibility and liquidity, and ensure carbon savings occur where they are least cost.

1. Introduction

Chapter Summary

The EU emissions trading scheme (EU ETS) is a market based instrument designed to ensure greenhouse gas emissions can be reduced at the lowest possible cost. The Commission is reviewing the EU ETS to improve the functioning of the scheme. This chapter sets out the context of the review and identifies what we see as the main issues.

Introduction

1.1. Ofgem welcomes the opportunity to contribute to the European Commission's Review of the EU emissions trading scheme (EU ETS). The improved functioning of the EU ETS will be crucial in helping the European Union meet its obligations under the Kyoto Protocol and the target to reduce greenhouse gas (GHG) emissions by 20 per cent from 1990 levels by 2020, set at the 2007 Spring European Council. The IPCC's updated projections of climate change, and the conclusions of the Stern Review, have further highlighted the need to reduce emissions and placed greater emphasis on the role of trading schemes. The review is an opportunity to improve the structure of the scheme and set a global standard on the design of trading schemes, which achieve carbon savings as well as help in meeting security of supply goals, and influence the development of an international carbon market.

1.2. The Commission's report analyses the performance of the scheme and sets out the terms of reference for the review. A European Climate Change Programme (ECCP) Working Group on the Review of the EU ETS will be addressing the issues, taking into account principles of environmental efficiency and the cost effectiveness of any proposed measures. The central themes that will be addressed in the review are expanding the scope of the scheme, increasing harmonisation and predictability, ensuring robust compliance and enforcement, and the involvement of third countries. The review will have important implications for gas and electricity markets and consumers across Europe.

1.3. This chapter sets out the context and our observations on the EU ETS to date. The next chapter sets out comments in relation to the specific issues the review will be focusing.

Context

1.4. We support broad based instruments as the most cost-effective way to achieve environmental objectives, in a manner that is compatible with competitive and liberalised markets across Europe. Market based instruments, like the EU ETS are efficient as they minimise the costs of compliance, and have the potential to spur innovation and technological change, which further lowers compliance costs.

1.5. The EU ETS is targeted at correcting the fundamental market failure of failing to include the external cost of greenhouse gas emissions. The price signal provided from the EU ETS should lead to an efficient level of investment in abatement measures.

1.6. A well functioning market in abatement can tackle uncertainties. If market participants are provided with the right signals they can make decisions about which technologies represent the best investment to deliver all the requirements of the electricity system. In a market with an emissions constraint we would expect the cheapest means to be exploited first, with the more expensive options gradually being used up to the point at which the emissions target is met and there is no need to pursue further abatement.

1.7. Within the EU ETS, if abatement in the UK is relatively expensive, UK firms can more cheaply comply with their obligations by buying allowances, and in doing so support lower cost abatement outside the UK. Similarly, if abatement in the UK is relatively low cost, UK firms can reduce emissions and sell allowances to participants in other countries. The allowance price will rise to the point where all the abatement required to meet the emission constraint across all participants is delivered.

1.8. In the short term participants can compare the cost of their own abatement options to the cost of buying allowances, the price of which reflects the lowest cost abatement options that others have at their disposal. In the longer term the traded carbon price sends a signal to technology investors about what their investments may be worth in the future. We recognise that under the current design the long term signals may not be sufficiently strong. However, this can be effectively addressed by reform of the existing scheme rather than abandoning a market-based approach.

1.9. If a market mechanism is not used and, instead, Member States adopt policies to support specific technologies, then there is a risk those technologies will not achieve the emission reductions at the lowest cost. In addition, it may increase the cost of achieving other objectives, such as security and diversity of supply. Supporting specific technologies reduces the scope for innovation and introduction of new technologies which may be better at delivering the requirements of the energy system. Provided appropriate long-term signals are in place, the decisions of market participants will bring forward an appropriate mix of technologies to meet environmental constraints as well as system security and diversity of supply.

1.10. We support the view that the emissions trading scheme is an essential instrument for achieving long and medium term emission reductions that are necessary to stabilise the level of greenhouse gas emissions and meet climate change targets.

1.11. However the EU ETS in its current form does not deliver any long term certainty to potential investors in carbon abatement technology. There is no long term certainty as to the level of abatement required by the EU ETS, and whether there will be a scheme at all in the longer term. While the market is well placed to

deal with normal economic and technological uncertainty, it is less able to deal with the impact of political uncertainty on investments.

1.12. Although the EU ETS is intended to deliver lowest cost abatement, there are a number of elements of the design which may prevent this. The existing form creates uncertainty, which derives from:

- The five year phases and caps not being set far enough in advance of each phase, and therefore not providing long-term certainty and predictability;
- The need for greater harmonisation across Member States, which would likely result in a more robust and efficient scheme - in respect to setting the cap centrally rather than by the aggregate of the national allocation plans, or by more coordinated and timely release of information across the different Member States;
- The scheme being relatively new and evolving, including issues such as definitions, coverage, market arrangements, relationship with flexible mechanisms; and
- The uncertain political environment, i.e. the Kyoto protocol and the lack of a successor agreement from 2013.

1.13. Other design elements which prevent the delivery of the required level of abatement at the lowest possible cost include:

- The restricted coverage of the scheme, which may be preventing low cost abatement options being exploited;
- The free allocation of allowances creates severe distributional impacts and large transfers between electricity customers and generators - particularly in the electricity generation sector - and is not the most equitable or efficient method of allocation;
- The absence of full auctioning of allowances leading to the need for rules regarding how new entry and plant closure will be treated - both of which can act to distort the incentives of the scheme and increase costs.

1.14. It was inevitable there would be a learning phase, where weaknesses and places where the scheme could be improved were highlighted. We also appreciate that some volatility should be expected in a developing market. We support the terms of reference set out in the review paper and the purpose to improve the efficiency of the scheme. The terms of reference cover many of the issues we have raised as essential for improving the functioning of the scheme.

1.15. Globally, climate change is receiving much greater attention and the IPCC findings published this year have highlighted the need for global political action. Their evidence shows global temperatures have continued to rise and they have observed acceleration in the rate of changes over the last few decades. The Stern Review, published in November 2006, emphasised the importance of the establishment of a single carbon price as an essential foundation for climate change policy. These provide more reason to improve the functioning of the scheme, and the importance of ensuring it is compatible with schemes in other countries.

1.16. The Commission's review of the Directive is therefore an opportunity to improve the scheme's efficiency, improve certainty and remove any perverse incentives. For the EU ETS to deliver to its maximum potential it should provide long-term signals, allocate allowances through an auctioning system and be broadened in scope. We consider the key areas that need to be addressed are:

- The scheme should be expanded to cover all major greenhouse gas emitting sectors, ensuring abatement occurs at lowest possible cost;
- Future phases should be longer than five years to improve certainty, and long-term targets would be more consistent with the timescales for investment;
- Allocation of allowances should be entirely through auctions as the most efficient allocation method. Revenue could be recycled into further research and investment and low carbon technologies or measures to reduce fuel poverty; and
- Greater harmonisation across all Member States will help to avoid damaging uncertainty and volatility and create a more robust and efficient scheme.

2. Main issues in the review

Chapter Summary

This chapter sets out our view on the four broad categories of issues which the review will address.

2.1. To focus the review process the Commission has identified a number of issues which the ECCP Working group will be addressing; they can be grouped into four broad categories:

- (1) The scope of the Directive
- (2) Further harmonisation and increased predictability
- (3) Robust compliance and enforcement
- (4) Links to third countries

(1) Scope of the Directive

2.2. The scheme currently covers major stationary sources of emissions but does not cover some sectors which are important in terms of emissions; it has been proposed that emissions from the aviation sector will be included in the scheme. The absence of other sectors and gases means that abatement may not be occurring at the lowest possible cost across the economy as a whole.

2.3. We would support the increased scope of the directive with further expansion of the scheme to cover other significant sectors. The scheme should have the broadest possible coverage so that abatement occurs at the lowest possible cost.

2.4. Currently the Directive applies on individual installations at point of emission; however including other sectors may require the Directive to be applied differently. In the case of aviation this will probably be on the company, however for small installations the obligation could potentially be moved to the fuel supply point. These adjustments and differences in the application of the Directive will add to the complexity of the scheme and it will be important to take this into consideration when deciding whether to broaden the scope.

Combustion and small installations

2.5. We would welcome greater clarity on the specific types of combustion installations that are covered by the Directive. This should ensure a consistent approach is taken across Member States on the interpretation of combustion installations and how the Directive is applied.

2.6. Environmental improvements should be made where they are most efficient, it is important to consider the cost effectiveness of covering small installations in EU ETS, and the administrative burdens on small installations in participating in the scheme. The Directive could potentially apply to the fuel supply point for small installations, which would reduce their administrative burdens. This would have to be weighed against increasing the complexity of the scheme.

Other sectors and gases

2.7. The scheme should also be expanded to cover emissions from other sectors and gases if feasible. The aim should be to remove any perverse incentives created by emissions which are not currently captured by the scheme. We do not have a view on which specific sectors should be included in the scheme but we urge the Commission to explore all possible options and seek agreement across Member States to avoid any distortions that may arise from inconsistent coverage.

Unilateral inclusion of additional activities and gases

2.8. Member States are currently able to unilaterally opt in additional sectors and gases, subject to approval by the Commission. However, in order to reduce distortions to competition associated with including additional sectors, a coordinated and harmonised approach will be required.

Carbon capture and geological storage

2.9. The extent that carbon capture and geological storage (CCS) activities will be recognised as carbon abatement under the EU ETS will require agreement across Member States. Given Europe's Energy Strategy proposal that all coal and gas fired plants will need to be fitted with CCS by 2020, there is likely to be strong support for its recognition as an abatement technique under the EU ETS. However any decision should be dependent on thorough assessment and the collection of sufficient evidence that CCS is technically, economically, and environmentally feasible.

(2) Further harmonisation and increased predictability

2.10. Further harmonisation is likely to result in a more robust and efficient scheme and less likely to result in a scheme that delivers the lowest possible standards. A harmonised scheme is less likely to allow special interest groups to pressurise individual Member States to put in place measures that distort incentives.

2.11. We have particular concerns regarding the treatment of new entry and closure, where Member States' actions can result in significant weakening of the signals to business to fully incorporate a cost of carbon in their investment and operational decisions. Full auctioning of allowances would resolve the issues related to new entry reserves and closure rules, making the scheme less complicated and reducing the administrative burden. In the absence of full auctioning for this phase, risks will

remain that rules relating to closure or new entrant reserve could lead to market distortions. To the extent that full auctioning of allowances is not achievable for this phase, in our view it would be best to allocate allowances in those sectors that face international competition (e.g. heavy manufacturing) and to auction allowances in those sectors that do not (e.g. energy) to reduce market distortions. Providing greater predictability and consistency will be essential in encouraging more long term investment in low carbon technologies.

Setting of the cap

2.12. An EU-wide cap would provide greater credibility and consistency. The level of the cap could be set to meet Europe's Kyoto Protocol obligations and also meet the target of a 20 per cent reduction in Europe's greenhouse gas emissions by 2020, which was set at the Spring European Council. A political agreement would be required to set the cap for the EU as a whole, with detailed negotiations among Member States on the distribution of the cap.

2.13. For the option of separate national caps that are determined by each Member State, it would be important to take into consideration the effect longer phases could have on mitigating issues related to long-term uncertainty.

2.14. The short-term nature of the current targets creates uncertainty that may mean expensive short-term abatement options are substituted for cheaper long-term abatement options. Long-term abatement options are likely to require substantial capital investment which may only provide sufficient return if CO₂ emissions are valued over the lifetime of the investment. In the absence of long-term abatement targets, investors may be unwilling to commit the required capital as the return is too uncertain. As a result, the only abatement options which are available are short-run options such as fuel-switching or reducing production.

2.15. This is a form of regulatory failure and could be addressed by providing greater certainty on long-term targets for example, through longer phases, perhaps combined with earlier submission of national allocation plans (NAPs). If targets were known further ahead, the start of the phase would provide up to 13 years of certainty on targets compared to the current 6.5 years. Alternatively, the NAPs could include proposed caps for two or more phases. Although this would provide an indication of likely scarcity, it would not eliminate the uncertainty.

Predictability

2.16. Certainty and credibility are essential for low carbon technologies as they require long term investment. There needs to be a predictable framework where investors are confident commitments are credible, as political uncertainty could severely undermine investments. Facing uncertainty investors may opt to invest in lower cost fossil based technologies.

2.17. Adjustments might be required as the scheme develops and expands to ensure there are not any inconsistencies or perversities, however the overall framework should remain consistent.

Allocation of allowances to sectors and installations

2.18. The harmonisation of the allocation methodologies for all Member States would provide consistency, transparency, and improve the simplicity of the scheme. We support full auctioning in the third phase of the EU ETS.

Auctioning

2.19. Full auctioning of allowances would be the most efficient mechanism for allocation and would reduce the administrative burden of implementing a methodology for free allocation.

2.20. Auctioning is the most efficient means of allocating allowances as it ensures that allowances are allocated to those who value them the most. Free allocation increases profits to generators as the opportunity cost of allowances is incorporated into the electricity price. Auctioning reduces this effect, which may improve public acceptability of the scheme particularly at times of high energy prices, and ensures the costs of emissions are incorporated in business decisions. The revenue from the scheme can be used in a number of ways, such as alleviation of fuel poverty through the compensation of those consumers most affected by increases in energy prices. Alternatively it could be used to fund policies designed to increase the long-term certainty of the carbon market. Auctioning the allowances could also resolve the issues regarding new entry reserves and closure.

2.21. Should full auctioning of allowances not be achievable for this phase, in our view it would be best to allocate allowances in those sectors that face international competition (e.g. heavy manufacturing) and to auction allowances in those sectors that do not (e.g. energy) to reduce market distortions. It may also be appropriate to make use of 'shadow schemes' in the interim to achieve this.

Free allocation

2.22. Allocation on the basis of historic emissions or relatively simple benchmarks is likely to be administratively simpler and less contentious than allocation on the basis of projections. We prefer the use of auctions for allocating allowances, however the use of benchmarks for the electricity generation sector has a number of benefits compared to other possible allocation methodologies.

2.23. Benchmarks introduce simplicity, transparency, and predictability into the allocation process. The use of a benchmark system minimises the effect of anomalies in historic data and reduces the incentives for gaming, as the impact of an individual plant history on its own allocation is significantly reduced. Benchmarks also reduce administrative costs. They do not overcome the drawback of the potential to increase

profits in markets where the allowance price is passed on to the consumer. Benchmarks should not be seen as mechanisms that provide incentives for particular action. The driving force to change behaviour and to influence investment in the EU ETS is the allowance price.

New Entrants

2.24. A more harmonised approach to new entrants across Member States will ensure greater consistency and comparable competition across the EU. We consider that the most efficient in terms of environment and cost outcomes would be to require new entrants to buy allowances.

2.25. The treatment of new entry is potentially an area where there may be risk that decisions made within the EU ETS may have a distortionary effect on markets. New entrant reserves may potentially be too generous to new entrants compared to incumbents, given the incentives to overestimate new entry requirement. Auctioning to allocate allowances for new entrants would avoid market distortions.

2.26. The existing practice in most Member States is allocation of allowances free to new installations which come within the boundaries of the scheme. This essentially acts as a subsidy to investment in new sources of carbon dioxide emissions and may result in over-investment in carbon intensive technologies and reduced investment in low-carbon technologies. This is exacerbated by the lack of long-term targets discussed above. Facing uncertainty about whether or not a carbon price will exist in the future, investors may opt to invest in lower cost fossil based technologies, knowing that in the short-term they will receive a free allocation of allowances.

2.27. If new entrant reserves are to be used they should be simple and transparent mechanisms for allocating allowances that will reduce uncertainty. There should be a harmonised approach across all Member States. In our view, new entrant reserves are unnecessary, particularly if allowances are auctioned.

2.28. Any definition of a new entrant should remain as narrow as possible in order to maintain the incentives of the scheme. A wide definition would lead to an administratively complex scheme and is contrary to the principles of emission trading. The mechanism should seek to minimise any perverse incentives.

2.29. As discussed above, to the extent that full auctioning of allowances is not achievable for this phase, in our view it would be best to allocate allowances in those sectors that face international competition (e.g. heavy manufacturing) and to auction allowances in those sectors that do not (e.g. energy) to reduce market distortions.

Installations that close

2.30. A closure regime where a facility permanently closing must forfeit its right to any undistributed emission allowances leads to perverse incentives to keep the plant open to retain access to the free allocation of allowances. This is unlikely to have a

security of supply benefit, and may result in higher costs and a loss in terms of the efficiency of the scheme. Auctioning to allocate allowances would avoid this problem.

2.31. It has been argued that this approach to closure is beneficial for security of supply as it maintains generation capacity on the system. However, if a plant remains on the electricity system, but only with a limited ability to generate, the apparent surplus capacity may discourage investment in new installations. The existence of surplus capacity may distort electricity prices and reduce the incentive for new capacity to be brought on to the system. If the old capacity is not capable of running beyond minimal levels, this may increase the risk of supply interruptions at peak times. These inefficient decisions represent a real loss to the efficiency of the scheme and will result in a higher cost to consumers, creating a false level of capacity which could be detrimental to the security of supply.

2.32. Our favoured approach would be for plant owners to retain emission allowances if a plant closes as we consider closure is a legitimate emission abatement option. The excess of allowances could be used to increase production from other facilities within that operator's portfolio, or sold to others, increasing the liquidity in the allowance market. This will remove the incentive for incumbents to keep obsolete plants open, and provide more accurate signals of supply requirements.

Monitoring and reports

2.33. A more structured and regular release of information may help prevent the carbon price volatilities observed in 2005. Accurate and timely information on actual emissions needs to be made available to all market participants.

2.34. Countries releasing their emissions data ahead of the EC's scheduled release date caused large variations in the carbon price. Ensuring a harmonised date, where all market participants receive the information at the same time should reduce uncertainty. Whether the market needs more information in a predictable manner and a regular release of data, for example once a quarter could be reviewed.

(3) Robust compliance and enforcement

2.35. Compliance and enforcement are essential for the effectiveness of the scheme and to provide credibility. Harmonisation across Member States will be important for consistency; however it will be important to balance any requirements with the additional administrative burdens this will place on participating in the scheme.

Monitoring and reporting

2.36. Harmonised reporting and monitoring will allow performance to be easily compared between Member States and should increase the transparency of the scheme. We would support EU-wide uniform standards on monitoring and reporting.

Verification and compliance

2.37. Compliance and independent verification of emissions is vital to the credibility of the EU ETS. This would benefit from a harmonised approach across Member States on the accreditation of verifiers.

(4) Linking with emissions trading schemes in third countries, and appropriate means to involve developing countries and countries in economic transition

Possibility of linking the EU ETS to schemes in third countries

2.38. Developing links with third countries may help to facilitate a movement towards a global emissions trading scheme in the future. Harmonising and linking the different schemes between countries early in their development should simplify the process of creating a global emissions trading scheme in the future. We favour any increase in the flexibility of the system, as this will ensure emission savings occur where they are most efficient. A well functioning international abatement market allows climate change targets to be met at minimum costs.

Developing countries and countries in economic transition

Decisions regarding the use of Kyoto mechanisms we consider are political decisions. However, we observe that the ability of participants to surrender credits from Kyoto Protocol flexible mechanisms allows an increase in the flexibility of the system and generates a possible reduction in the allowance price, therefore reducing compliance costs and increasing liquidity of the system. We would support greater harmonisation across Member States in the use of Kyoto credits. The contribution projects are making to shift economies to more sustainable paths will be particularly important due to the growth in emissions from developing countries and their increasing contribution to climate change.

Appendices

Index

Appendix	Name of Appendix	Page Number
1	The Authority's Powers and Duties	15
2	Glossary	17

Appendix 1– The Authority’s Powers and Duties

1.1. Ofgem is the Office of Gas and Electricity Markets which supports the Gas and Electricity Markets Authority (“the Authority”), the regulator of the gas and electricity industries in Great Britain. This Appendix summarises the primary powers and duties of the Authority. It is not comprehensive and is not a substitute to reference to the relevant legal instruments (including, but not limited to, those referred to below).

1.2. The Authority’s powers and duties are largely provided for in statute, principally the Gas Act 1986, the Electricity Act 1989, the Utilities Act 2000, the Competition Act 1998, the Enterprise Act 2002 and the Energy Act 2004, as well as arising from directly effective European Community legislation. References to the Gas Act and the Electricity Act in this Appendix are to Part 1 of each of those Acts.¹

1.3. Duties and functions relating to gas are set out in the Gas Act and those relating to electricity are set out in the Electricity Act. This Appendix must be read accordingly².

1.4. The Authority’s principal objective when carrying out certain of its functions under each of the Gas Act and the Electricity Act is to protect the interests of consumers, present and future, wherever appropriate by promoting effective competition between persons engaged in, or in commercial activities connected with, the shipping, transportation or supply of gas conveyed through pipes, and the generation, transmission, distribution or supply of electricity or the provision or use of electricity interconnectors.

1.5. The Authority must when carrying out those functions have regard to:

- The need to secure that, so far as it is economical to meet them, all reasonable demands in Great Britain for gas conveyed through pipes are met;
- The need to secure that all reasonable demands for electricity are met;
- The need to secure that licence holders are able to finance the activities which are the subject of obligations on them³; and
- The interests of individuals who are disabled or chronically sick, of pensionable age, with low incomes, or residing in rural areas.⁴

1.6. Subject to the above, the Authority is required to carry out the functions referred to in the manner which it considers is best calculated to:

¹ entitled “Gas Supply” and “Electricity Supply” respectively.

² However, in exercising a function under the Electricity Act the Authority may have regard to the interests of consumers in relation to gas conveyed through pipes and vice versa in the case of it exercising a function under the Gas Act.

³ under the Gas Act and the Utilities Act, in the case of Gas Act functions, or the Electricity Act, the Utilities Act and certain parts of the Energy Act in the case of Electricity Act functions.

⁴ The Authority may have regard to other descriptions of consumers.

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- Promote efficiency and economy on the part of those licensed⁵ under the relevant Act and the efficient use of gas conveyed through pipes and electricity conveyed by distribution systems or transmission systems;
 - Protect the public from dangers arising from the conveyance of gas through pipes or the use of gas conveyed through pipes and from the generation, transmission, distribution or supply of electricity;
 - Contribute to the achievement of sustainable development; and
 - Secure a diverse and viable long-term energy supply.

1.7. In carrying out the functions referred to, the Authority must also have regard, to:

- The effect on the environment of activities connected with the conveyance of gas through pipes or with the generation, transmission, distribution or supply of electricity;
- The principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed and any other principles that appear to it to represent the best regulatory practice; and
- Certain statutory guidance on social and environmental matters issued by the Secretary of State.

1.8. The Authority has powers under the Competition Act to investigate suspected anti-competitive activity and take action for breaches of the prohibitions in the legislation in respect of the gas and electricity sectors in Great Britain and is a designated National Competition Authority under the EC Modernisation Regulation⁶ and therefore part of the European Competition Network. The Authority also has concurrent powers with the Office of Fair Trading in respect of market investigation references to the Competition Commission.

⁵ or persons authorised by exemptions to carry on any activity.

⁶ Council Regulation (EC) 1/2003

Appendix 2 - Glossary

A

Allowances (EU Allowances)

European Allowance Units are issued to installations which have a cap on their emissions under the EU Emissions Trading Scheme. An installation must hold and surrender EU allowances and/or project based carbon credits equal to its monitored carbon dioxide emissions by the annual EU ETS reconciliation date. EU allowances are also the main unit which will be traded in the EU ETS. One EU allowance = 1 t CO₂e.

C

Carbon capture and geological storage (CCS)

CCS is a technology concept to reduce the atmospheric emissions of carbon dioxide that result from various industrial processes, in particular from the use of fossil fuels (mainly coal and natural gas) in power generation. It involves capturing carbon dioxide (CO₂) from large point sources such as power plants and subsequently storing it away safely instead of releasing it into the atmosphere.

E

Emissions Trading

A system allowing the trade of emission reduction credits, to facilitate compliance with emissions allowances at least cost.

EU Emissions Trading Scheme (EU ETS)

A cap and trade scheme in which EU Member State Governments are required to set emissions limits for all installations in their country covered by the scheme. It is an administrative approach used to reduce the cost of pollution control by providing economic incentives for achieving reductions in the emissions of pollutants.

European Climate Change Programme (ECCP)

The European Climate Change Programme (ECCP) was launched in June 2000 by the European Commission. The goal of the ECCP is to identify, develop and implement all the necessary elements of an EU strategy to implement the Kyoto Protocol.

I

[InterGovernmental Panel on Climate Change \(IPCC\)](#)

The role of the IPCC is to assess on a comprehensive, objective, open and transparent basis the scientific, technical and socio-economic information relevant to understanding the scientific basis of risk of human-induced climate change, its potential impacts and options for adaptation and mitigation.

K

[Kyoto credits](#)

These are assigned for emissions reductions. There are four types of Kyoto credit - Assigned Amount Units, Certified Emission Reductions, Emission Reduction Units, and Removal Units. The former are allocated to countries who have Kyoto Protocol targets, and the latter three types are generated through different types of projects.

[Kyoto mechanisms](#)

There are three Kyoto Mechanisms which can assist a country to achieve its emissions target, in addition to domestic action. These are Emissions Trading, Joint Implementation and the Clean Development Mechanism.

[Kyoto Protocol](#)

This is an international agreement which builds on the United Nations Framework Convention on Climate Change. It sets legally binding targets and timetables for cutting the greenhouse-gas emissions of industrialised countries.

N

[National allocation plans \(NAPS\)](#)

Each EU Member State is required to produce a National Allocation Plan (NAP) setting out the total quantity of allowances that it intends to allocate in a phase. The NAP also lists each installation covered by the EU ETS and how Member States propose to allocate allowances to those installations (Article 9 of the Directive). NAPs must be based on objective and transparent criteria including those set out in Annex III of the Directive.

S

[Stern Review](#)

Sir Nicholas Stern, Head of the Government Economics Service and Adviser to the Government on the economics of climate change and development published the Stern Review on the Economics of Climate Change in October 2006. The report discusses the effect of climate change and global warming on the world economy